

**IN THE MATTER OF THE APPLICATION REGARDING CONVERSION
OF PREMIER BLUE CROSS AND ITS AFFILIATES**

Washington State Insurance Commissioner's Docket # G02-45

PRE-FILED DIRECT TESTIMONY OF:

Richard P. Fox

March 31, 2004

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Introduction

Q. Please state your name, title, employer and business address.

A. Richard P. Fox. I am a Partner with RavenFire LLC. My business address is P.O. Box 558, Mercer Island, WA.

Q. What is your relationship to Premera Blue Cross?

A. I am an independent director of the PREMERA and Premera Blue Cross Boards of Directors. I have served on the PREMERA and Premera Blue Cross boards since May 2000. I currently serve as the Chair of the Audit and Compliance Committee and as a member of the Investment Committee.

Purpose and Conclusions of Testimony

Q. What is the purpose of your testimony?

A. I will describe the role of the Premera Board's Audit and Compliance Committee in overseeing Premera's internal controls, financial reporting, and readiness to become a public company. I will also explain why the Board believes that Premera should enhance its capital position and that a conversion to for-profit status is the best alternative for raising capital.

Q. What are the primary conclusions to be drawn from your testimony?

A. There are four main conclusions. First, the Board has a strong commitment to the integrity of the company, as evidenced by its oversight of internal controls, financial reporting, and corporate compliance with laws and ethical standards. The Audit and Compliance Committee operates independently from Premera management. Second, the Audit and Compliance Committee operates according to best practices for a non-profit corporation subject to regulation under the insurance code and other applicable laws. Third, Premera has a long history of adopting best practices related to audit and

1 compliance functions such as its adoption of the recommendations of the Blue Ribbon
2 Commission on the Effectiveness of Audit Committees, and early adherence to the
3 applicable provisions of the Sarbanes-Oxley Act. Finally, the Board believes that
4 Premera should enhance its capital position and that a conversion to for-profit status is
5 the best alternative for raising capital.

6 **Qualifications**

7 **Q. Please summarize your educational background.**

8 A. I graduated from Ohio University in 1969 with a Bachelor of Business
9 Administration degree in Accounting. I am a Certified Public Accountant licensed in the
10 state of Washington.

11 **Q. Please summarize your business background.**

12 A. I am currently a partner with RavenFire LLC, a management consulting firm.
13 Previously, I served as President and Chief Operating Officer of CyberSafe Corporation;
14 Vice President, Chief Financial Officer and Director of Wall Data, Inc.; and Senior Vice
15 President of PACCAR, Inc. From 1969 through 1997, I held numerous positions with
16 Ernst & Young LLP, last serving as the Managing Partner of the Seattle office.

17 **Q. Aside from your employer and Premera, what organizations are you active
in?**

18 A. I am a trustee of the Seattle Foundation and a member of the Board of Visitors of
19 the Fuqua School of Business at Duke University. In addition, I am active in fund raising
20 at the Fred Hutchinson Cancer Research Center. I serve on the advisory committee of
21 Northwest Venture Associates, a local venture capital fund. I am also on the Board of
22 Directors of Fulcrum Technologies, a software developer and integrator; aQuantive, an
23
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Internet marketing company; Flow International, a machine tool manufacturer; and Shurgard Storage Centers, Inc., a worldwide provider of personal and business storage.

Premera's Internal Controls

Q. Please summarize the charter of the Audit and Compliance Committee of the Board.

A. The charter of the Audit and Compliance Committee is to ensure the integrity and reliability of the company's financial statements, and to ensure that the company operates ethically, complies with applicable laws, and has adequate internal controls. The Audit and Compliance Committee assists the Board in its oversight of the integrity of Premera's financial statements; Premera's financial reporting process; Premera's systems of internal accounting and financial controls; the performance of the company's internal audit function and internal auditors; and the external auditor's qualifications and independence. If Premera becomes publicly traded, we will also oversee the preparation of the financial reports required by applicable securities laws and regulations. In addition, the Audit and Compliance Committee assists the Board in its oversight of Premera's Code of Business Conduct, compliance with legal and regulatory requirements, and its Compliance and Ethics Program.

Q. As Chair of the Audit and Compliance Committee, what are your main responsibilities?

A. I work with committee members and Premera management to review issues that the Audit and Compliance Committee should consider, based upon the charter described in the previous question. We meet quarterly or more often if required. I set the agenda for each meeting, according to the Audit and Compliance Committee plan and after speaking separately with the Chief Financial Officer, the Vice President of Internal Audit, the Vice President, Compliance and Ethics Officer, and our independent auditor. I chair

1 the meetings and serve as the liaison between the Audit and Compliance Committee, the
2 Board, and Premera management between meetings. At Board meetings, I report on the
3 activities, processes and decisions of the Audit and Compliance Committee.

4 **Q. To the best of your knowledge, does the Audit and Compliance Committee**
5 **meet all applicable regulatory requirements?**

6 A. Yes. Even before the Board reached the decision that Premera should convert to
7 for-profit status, we used the best practices of public companies as a benchmark. For
8 example, Premera amended its bylaws to require that the composition of the Audit and
9 Compliance Committee consists exclusively of members who are independent, non-
10 management Board members. The Board and the Committee also adopted a charter for
11 the Committee that is consistent with the recommendation of the Blue Ribbon
12 Commission on the Effectiveness of Audit Committees. We are currently implementing
13 changes to comply with the Sarbanes-Oxley Act and other rules and regulations
14 applicable to public companies, even before we are required to do so. The Board's
15 objective is to implement best practices with respect to how audit committees should
16 operate, considering such requirements as those contained in Sarbanes-Oxley.
17 Accordingly, we reviewed our processes and procedures with the help of outside legal
18 counsel and an independent auditor to determine what changes needed to be made.
19 Based on that review, we re-worked our charter, membership, and procedures to comply
20 with the Act.

21 We recently completed a self-appraisal of how well we are meeting applicable
22 Sarbanes-Oxley requirements, using a procedure developed by an outside accounting
23 firm. The appraisal validated that we have done an excellent job thus far of
24 implementing the Act's requirements, and it helped us identify next steps. For example,

1 in 2004 our goal is to achieve compliance with Section 404 of Sarbanes-Oxley, which
2 focuses on identifying and documenting internal controls and ensuring that the controls
3 work as intended. This will enhance our current audit programs.

4 **Q. What procedures are in place to ensure that the Audit and Compliance
Committee is independent from Premera management?**

5
6 A. There are several procedures outlined in our charter that help ensure the Audit and
7 Compliance Committee's independence. All Committee members are independent—that
8 is, they have no material relationship with Premera. Our Committee meets in executive
9 session (without Premera management) with Premera's internal auditor, compliance
10 officer, and independent auditors. We have the authority to appoint, retain or replace the
11 company's independent auditor, as well as to review and approve the appointment,
12 dismissal and replacement of the Vice President-Internal Audit and Vice President-
13 Compliance and Ethics Officer. In addition, we go into executive session without any
14 Premera executives or other employees present whenever necessary.

15 **Q. What process does Premera have in place to identify and evaluate material
risk?**

16 A. Our internal audit department and independent auditors complete a risk
17 assessment each year, or more often if needed. The internal audit assessment identifies
18 discrete, high-risk areas across the company that we plan to audit during the year. The
19 risk assessment criteria include quality of internal controls, management experience, size
20 of the area or transaction volume, complexity, susceptibility to fraud, and regulatory
21 requirements.

22 The Audit and Compliance Committee receives quarterly reports on the critical
23 accounting areas of the company. For example, we receive and review reports on our
24 medical claims liability and valuation of available-for-sale securities each quarter, noting

1 the magnitude, degree of subjectivity and conservatism applicable to each of these
2 estimates.

3 **Q. Do you have confidence in the experience, integrity and training of the**
4 **company's key management and auditing personnel?**

5 A. Absolutely. One of the Audit and Compliance Committee's main responsibilities
6 is to assess "the tone at the top." In other words, it is our job to judge whether Premera's
7 leadership has the integrity, honesty, and other values needed to run the company in a
8 principled manner. This isn't something you can measure directly, but based on our
9 Committee's observations, we are confident that Premera's leaders are setting the right
10 tone for the entire organization.

11 In addition, this past year the Audit and Compliance Committee retained an
12 independent firm to review our internal audit function. We received a positive report on
13 the quality of our internal audit processes and on the effectiveness of our staff. Every
14 year, we evaluate the performance of the independent auditors as well and decide if they
15 should be retained for another year, or if any changes are required.

16 Last year we also retained an outside consultant with nationally recognized
17 expertise to conduct an independent assessment of our Compliance and Ethics program.
18 The consultant found that Premera had a strong foundation in place that met all of the
19 minimum requirements expected of compliance and ethics programs, and that many best
20 practices were already in place or planned for the near future. We have also incorporated
21 several Sarbanes-Oxley requirements into our Compliance and Ethics program.

22 The Audit and Compliance Committee is also quite confident in the capabilities of
23 Premera's senior finance staff. Although the Audit and Compliance Committee is not
24

1 directly responsible for reviewing the performance of the finance staff, Premera's Chief
2 Executive Officer routinely seeks our opinion.

3 **Q. How responsive is Premera management to a material negative finding in an
4 internal audit report?**

5 A. Premera management deals with the internal audit function in a very professional
6 manner, taking action to address findings and recommendations raised in audit reports.
7 For example, an audit in a prior year recommended that the company should establish a
8 more extensive business continuity plan. Implementing such a plan is an expensive effort
9 that requires significant investment and staff time. In response, the Chief Executive
10 Officer made business continuity a priority initiative and assigned a high-level executive
11 to spearhead development of the plan. The project receives significant annual funding
12 and the Audit and Compliance Committee receives regular reports on progress against
13 plan.

14 **Premera's Preparedness to Become a Public Company**

15 **Q. From your perspective as the Chair of the Audit and Compliance Committee,
16 what is Premera's readiness to be a public company?**

17 A. I am quite confident that we have the people and processes in place to make a
18 successful transition to being a publicly traded company. We have used the Sarbanes-
19 Oxley Act and supporting regulations as our guide for structuring the Audit and
20 Compliance Committee of the Board, as well as for Premera's internal controls and
21 disclosure processes. We have retained outside experts to review our processes and
22 recommend how we can do an even better job. We have done all of this work not just to
23 prepare for going public, but to implement what we believe is best practices for any
24 company.

1 **Q. If Premera becomes a publicly traded company, what changes will the Audit**
2 **and Compliance Committee need to make to its member composition,**
3 **independence from Premera management, or procedures?**

4 A. Our basic processes, Board and Committee composition, and independence from
5 management will not need to change, as we have already adopted many best practices.
6 Once Premera is public, we will of course need to meet all of the required Securities
7 Exchange Commission filing requirements, as well as disseminate quarterly earnings
8 releases. To prepare our internal staff for those responsibilities, we have initiatives in
9 place that includes the preparation of mock SEC filings and press releases. Overall, we
10 are well prepared to make the transition.

11 **Financial Case for the Conversion**

12 **Q. As Chair of the Audit and Compliance Committee, how would you**
13 **characterize Premera's current financial situation?**

14 A. Although the company is profitable and has been for the past few years, it needs
15 access to additional capital for several reasons. We've invested large sums in new
16 information systems, but the demands on our resources are constant. We need to
17 continually invest in infrastructure upgrades and new technology to enhance customer
18 service and support new product development. In addition, as a board member I have
19 come to understand just how heavily regulated Premera's business is. Laws and
20 regulations related to health insurers tend to be complex, and implementation and
21 compliance is generally costly. For example, the implementation of the federal Health
22 Insurance Portability and Accountability Act has cost Premera over \$34 million since
23 2000. Finally, our capital level is low compared with other Blue plans around the
24 country. We need to add to our reserves, which will give us more financial flexibility and
greater capacity for membership growth.

1 **Q. Why does Premera need better access to capital, and how will the proposed**
2 **conversion to for-profit status improve Premera's access to capital?**

3 A. Currently we have one source of capital: positive operating results. Our profit
4 margins are improving but thin, as is common in the industry. So it will be very difficult
5 to fund meaningful membership growth or make needed investments through profits
6 alone. The Board has determined that access to equity capital is the best way to give the
7 company financial flexibility while bolstering reserves.

8 **Q. Given the various ways Premera can raise capital, why does the Board**
9 **consider conversion to for-profit status to be the best approach?**

10 A. The Board considered several alternatives. One was to sell parts of the business,
11 such as an operating subsidiary. But we determined that all of our operating subsidiaries
12 are important to the company's strategic direction. Another alternative was to borrow
13 using subordinated surplus notes. The amount that can be raised through a surplus notes
14 offering would be limited to a relatively small percentage of current statutory capital and
15 would not provide an ongoing source of capital. We also considered affiliation or merger
16 as an alternative. Affiliating or merging with another company with different goals
17 would be inconsistent with our reasons for seeking capital. The Board is committed to
18 Premera's mission and vision and seeks capital to pursue the products and services we
19 believe bring unique value to our current and future members.

20 The Board evaluated other alternatives as well. We concluded that accessing the
21 capital markets, which requires conversion, is the right course.

22 **Q. Does this conclude your testimony?**

23 A. Yes, it does.
24

VERIFICATION

I, RICHARD P. FOX, declare under penalty of perjury of the laws of the State of Washington that the foregoing answers are true and correct.

Dated this ____ day of March, 2004, at Seattle, Washington.

/s/

RICHARD P. FOX